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Nos. 82-599 and 82-774

In the Supreme Court of the United States

OCTOBER TERM, 1983

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

FRED L. ENGLE, ET UX.

PHILIP D. FARMAR, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT AND THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT (FORMERLY THE UNITED STATES COURT OF CLAIMS)

REPLY BRIEF FOR THE COMMISSIONER

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TABLE OF AUTHORITIES

Page

Cases:

Dalehite v. *United States*, 346 U.S. 15 5

Dixon v. *United States*, 381 U.S. 68 9

Douglas v. *Commissioner*, 322 U.S. 275 7

Glass v. *Commissioner*, 76 T.C. 949 ..... 4, 8

Helvering v. *Twin Bell Oil Syndicate*, 293 U.S. 312 2

Herring v. *Commissioner*, 293 U.S. 322 ..... 3, 4

Manhattan General Equipment Co. v. *Commissioner*, 297 U.S. 129 9

Shamrock Oil & Gas Corp. v. *Commissioner*, 35 T.C. 979 7

Wendland v. *Commissioner*, 79 T.C. 355 9

Statutes:

Internal Revenue Code (26 U.S.C. (& Supp. V)):

Section 613 ..... 2, 3
Section 613(a) 2
Section 613(d) 3
Section 613A ..... *passim*
Section 613A(b)(1)(B) 5
Section 613A(b)(2)(A) 5
Section 613A(c) 4
Section 613A(c)(1) 5
Section 613A(c)(1)(A) 2
Section 613A(c)(1)(B) 2
Section 613A(c)(2) 5, 6
Section 613A(c)(2)(A) 2, 4, 5

Page

Statutes—Continued:

Section 613A(c)(3) 4
Section 613A(c)(3)(A)(ii) 4
Section 613A(c)(3)(B) 4, 6
Section 613A(c)(5) 6
Section 613A(c)(8) 5
Section 613A(e)(1) 5
Section 613A(e)(2) 5
Section 7805 8
Section 7805(a) 9
Section 7805(b) 9

Revenue Act of 1925, ch. 27, 44 Stat. 9 *et seq.*:

§ 204(c)(2), 44 Stat. 16 3
§ 214(a)(9), 44 Stat. 27 3

Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 *et seq.* 3

Miscellaneous:

Bravenec, *Continued Availability of Percentage Depletion on Oil and Gas*, 23 Oil & Gas Tax Q. 204 (1975) 6

Burke & Russell, *The New Percentage Depletion Rules*, 24 Oil & Gas Tax Q. 13 (1975) 6

Fambrough, *Taxation of Oil and Gas Payments Received Independent of Production*, 31 Oil & Gas Tax Q. 873 (1983) 7

H.R. 17488, 93d Cong., 2d Sess. (1974) 5, 6

H.R. Conf. Rep. No. 94-120, 94th Cong., 1st Sess. (1975) 6

Page

Miscellaneous—Continued:

H.R. Rep. No. 704, 73d Cong., 2d Sess. (1934), *reprinted in* 1939-1 Cum. Bull. (Pt. 2) 554 9

H.R. Rep. No. 93-1502, 93d Cong., 2d Sess. (1974) 5

Note, *Availability of the Percentage Depletion Deduction for Oil Lease Payments,* 36 Tax Law. 817 (1983) 8

Orbach, Dickens & Fields, *A Percentage Depletion Allowance Alternative to* Engle *and* Glass, 31 Oil & Gas Tax Q. 255 (1982) 8

Proposed Treasury Regulations on Income Tax, 42 Fed. Reg. (1977):

p. 24281 ..... 8, 9
p. 24287 8

H. Williams & C. Meyers, *Oil and Gas Terms* (4th ed. 1976) 7

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ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT AND THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT (FORMERLY THE UNITED STATES COURT OF CLAIMS)

REPLY BRIEF FOR THE COMMISSIONER

In our opening brief, we argued that the language of Section 613A of the Internal Revenue Code (26 U.S.C.) coupled with its legislative history demonstrate clearly that Congress intended to tie the availability of the depletion allowance to the actual production of oil and gas and therefore Congress intended to withdraw the allowance for lease bonuses and advance royalties, which are unrelated to production for the taxable year. Taxpayers have presented several arguments in response that warrant a brief reply.

1. Taxpayers contend primarily (Engle Br. 9-10; Farmar Br. 7) that Section 613A of the Internal Revenue Code merely places a limitation on the maximum allowable percentage depletion deduction and does not impose any production requirement. The language of the statute, however, compels the conclusion that the allowance is based on the *actual production* of oil and gas. Section 613A states that the percentage depletion allowance shall be computed "with respect to—(A) so much of the taxpayer's average daily production" of oil or gas as does not exceed a specified quantity. Section 613A(c)(1)(A) and (B). The "average daily production" is computed by dividing the total production of oil and gas "during the taxable year" by the number of days in the year. Section 613A(c)(2)(A).

Taxpayers here received lease bonuses (J.A. 7, 9) and advance royalties (82-599 Pet. App. 17a-19a) that were not based on the actual production of oil and gas during their respective taxable years. Therefore, having no "average daily production" of oil or gas, taxpayers have nothing under Section 613A "with respect to" which percentage depletion may be computed under Section 613.[1]

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[1]Section 613 is, as the Farmars acknowledge (Br. 9), a computational statute. See *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312, 319 (1934). Congress did not intend Section 613 to be read as an independent section granting an allowance or deduction for depletion. The availability of the deduction must be found in other Code sections. 293 U.S. at 319. Thus, Sections 613 and 613A are not to be read independently, as the Farmars argue (Br. 9), but instead must be viewed in the overall scheme of congressional intent to base the percentage depletion allowance on the actual production of oil and gas. Before payments qualify as "gross income from property" under Section 613, they must first meet the "average daily production" requirement of Section 613A "with respect to" which the allowance is available (Section 613A(c)(1)(A) and (B)). As the Tax Court stated in *Engle* (82-599 Pet. App. 28a), once the taxpayer demonstrates production that satisfies Section 613A, the taxpayer then looks to Section 613(a) in order to carry over to the final computation the many Treasury Regulations,

2. Notwithstanding the clarity with which Congress linked the availability of the depletion allowance to production, taxpayers argue (Engle Br. 4-5, 9; Farmar Br. 7, 16) that the language "with respect to" production should be disregarded in order to avoid overturning 50 years of depletion allowance law that had developed from this Court's interpretations of a completely different statute. In making this argument, however, taxpayers disregard the fact that Congress in the Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 *et seq.*, effectively repealed percentage depletion for oil and gas and replaced it with a very limited form of percentage depletion for a few specifically defined categories, which were retained to encourage increased production of oil and gas.

Congress's repeal wiped clean the slate from which this Court reached its conclusion in *Herring* v. *Commissioner*, 293 U.S. 322, 324 (1934). The statute in *Herring* (the Revenue Act of 1925, ch. 27, §§ 204(c)(2), 214(a)(9), 44 Stat. 16, 27) permitted an allowance for depletion of 27.5% of the "gross income from property." That Act thus provided an unqualified deduction for all gross income from oil and gas properties. Based on this language, this Court found no congressional intent to differentiate between cost and percentage depletion:

> [T]he nature and the purpose of the allowance is the same in both cases [of cost and percentage depletion], and we find neither statutory authority nor logical justification for withholding it in the one and granting

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revenue rulings, and court opinions which have interpreted how the "gross income from the property" and the "taxable income from the property" are to be computed. This interpretation is consistent with Section 613(d), which states that "[e]xcept as provided in section 613A, in the case of any oil or gas well, the allowance for depletion shall be computed without reference to [Section 613]."

> it in the other; much less for making the decision turn upon the circumstance that no production is obtained within the year in which the bonus is paid.

Herring v. *Commissioner, supra,* 293 U.S. at 327-328. In contrast, the current law embodied in Section 613A erects a restrictive barrier to the allowance of percentage depletion by establishing a ceiling on the amount of the deduction and requiring that the deduction be based on the actual production of oil and gas.[2] See Section 613A(c)(2)(A) and (3). Congress thus decided in 1975 to provide different standards for cost and percentage depletion, allowing cost depletion in many cases where percentage depletion would not be available because percentage depletion was regarded as no longer necessary to encourage production. As Judge Goffe pointed out in his concurring opinion in the Tax Court in *Engle* (82-599 Pet. App. 40a), "*Herring* simply does not apply" to advance payments received after the enactment of Section 613A. See also *Glass* v. *Commissioner,* 76 T.C. 949, 958 (1981).

3. The Farmars assert (Br. 7) that Section 613A was passed "without any apparent consideration" of its effect on advance payments that are not based on actual production.

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[2]Taxpayers contend (Engle Br. 9-12; Farmar Br. 11) that Congress intended the percentage depletion deduction to be allowed "with respect to" the future production of oil and gas. As the Tax Court in *Engle* (Pet. App. 30a) and the Court of Claims in *Farmar* (82-599 Pet. App. 64a) noted, Section 613A(c) does not merely refer to production in general. The statute refers instead to a taxpayer's production "for the taxable year" (Section 613A(c)(3)(A)(ii)) and depletable quantities of oil are measured in terms of "barrels" of "production during the calendar year," Section 613A(c)(3)(B). The "average daily production" is also measured "during the taxable year." Section 613A(c)(2)(A). Production, as we indicated in our opening brief (at 20), means marketable oil and gas. See *Glass* v. *Commissioner,* 76 T.C. 949, 955 (1981). Because taxpayers' advance payments were not based on the actual production of marketable oil or gas, percentage depletion is unavailable. There is no basis in either the statutory language or its legislative history for reading the word "future" into Section 613A(c)(3).

As we indicated in our opening brief (at 24-26), however, the House discussed lease bonuses in an earlier report, stating "a lease bonus paid to the lessor of mineral lands in a lump sum or in installments is independent of any actual production from the lease and thus would not be within any of the exemptions." H.R. Rep. No. 93-1502, 93d Cong., 2d Sess. 46 (1974). While perhaps not dispositive, the House Report is obviously relevant and helpful in interpreting Section 613A. This Court has specifically recognized that legislative statements made with regard to unenacted bills in a prior Congress can "show[ ] most clearly" "[t]he meaning" of a provision enacted by a later Congress. *Dalehite* v. *United States*, 346 U.S. 15, 26 (1953). See also *id.* at 27-28.

Taxpayers' argument (Engle Br. 14-15; Farmar Br. 18-22) that the House Report is irrelevant asks this Court to disregard the best evidence available of what Congress probably intended by the provision it enacted. Their contention ignores the striking similarity in language and approach between Section 613A as finally enacted and the bill reported out of committee the previous year that was the subject of the House Report. As we pointed out in our opening brief (at 31-32), the definition of "average daily production" with its emphasis on production "during the taxable year" is identical in both versions. Compare Section 613A(c)(2)(A), with H.R. 17488, 93d Cong., 2d Sess. § 112(b)(2) (1974).[3] In addition, the structure of the proposed

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[3]Other provisions of H.R. 17488 were also very similar to the final version of Section 613A. Compare Section 613A(e)(1) and (2), with H.R. 17488, *supra*, § 111 (definition of crude oil); Section 613A(b)(1)(B) and 2(A), with H.R. 17488, *supra*, § 112(h)(7) (definition of natural gas sold under a fixed contract); and Section 613A(c)(8), with H.R. 17488, *supra*, § 112(b)(4) (aggregation rules for related taxpayers). See also H.R. Rep. No. 93-1502, *supra*, at 26-27, 48-49, and 53-54. In these circumstances, it is most unlikely that the proponents of Section 613A in the 94th Congress did not rely upon H.R. 17488 as reported out of committee in the 93d Congress.

H.R. 17488, with its elimination of the percentage depletion allowance and the 3,000 barrel limitation on production, is also remarkably similar to Section 613A. These similarities are not the product of coincidence.[4] As the Court of Claims reasoned in *Farmar* (82-599 Pet. App. 70a), "[t]he idea of a special exemption for small entities, expressly involving production, was very much in the air in the 94th Congress, and it is not unlikely that the prior report was known to several, if not many, of the members who considered § 613A," and almost certainly to those who proposed that Section 613A be added to the tax reduction bill.[5]

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[4]Even a critic of the Commissioner's interpretation has acknowledged that provisions of H.R. 17488 and Section 613A are "comparable," and that a similar production requirement was referred to in H.R. 17488 and explained in the House Report. See Bravenec, *Continued Availability of Percentage Depletion on Oil and Gas*, 23 Oil & Gas Tax Q. 204, 211 n.17 (1975) and accompanying text. See also Burke & Russell, *The New Percentage Depletion Rules*, 24 Oil & Gas Tax Q. 13, 15 (1975) (committee report on H.R. 17488 should have some bearing on final regulations under Section 613A).

[5]The only legislative history taxpayers rely upon (Engle Br. 7-8; Farmar Br. 18-19) is the Conference Report on Section 613A, which states that "the Senate amendment retains percentage depletion at 22 percent * * *." See H.R. Conf. Rep. No. 94-120, 94th Cong., 1st Sess. 67-68 (1975). As we discussed in our opening brief (at 29-31), however, the Conference Committee's simple use of the word "retains" cannot, in the overall legislative context, be fairly read to imply that the entire pre-existing body of case law for percentage depletion was to be retained for independent producers. Section 613A constituted a general repeal of percentage depletion for the oil and gas industry. A maximum depletable oil quantity was adopted, see Section 613A(c)(3)(B); the rate for percentage depletion was gradually lowered from 22 percent to 15 percent, see Section 613A(c)(5); and the allowance was based on a taxpayer's average daily production of oil or gas, see Section 613A(c)(2). In the face of these and other changes, prior law can hardly be said to have been "retained." Indeed, even the Seventh Circuit in *Engle* declined to rely on the Conference Committee's use of the word "retains" in reaching its decision (see 82-599 Pet. App. 12a).

The Engles argue (Br. 9-13) that there is no logical reason to condition the availability of the depletion allowance upon production. Aside from the fact that the argument is being presented to the wrong branch of government—Congress imposed the requirement—it overlooks the domestic oil and gas crisis that faced Congress in 1975. Obviously, if an advance royalty payment, for which a depletion allowance is granted, must be returned to income only at the expiration of the lease (ordinarily 5 to 10 years), as was the case prior to 1975, *Douglas* v. *Commissioner*, 322 U.S. 275 (1944), the lessor has little incentive to encourage immediate production on his property. He has money in hand and a sizeable tax benefit for property he obviously had no intention to put to any immediate, alternative use. If, however, the holder of the advance royalty loses the depreciation allowance unless production is sufficient to justify it, then the lessor has a strong incentive to encourage the lessee to produce immediately. This production incentive is perfectly logical in light of the oil and gas shortages that existed in the 1970's.

4. The Farmars argue (Br. 24-26) that, even assuming the Commissioner is correct that the allowance is available only when oil or gas is actually produced, they are entitled to percentage depletion because their properties produced some oil and gas in 1976. The Farmars, however, received a lease bonus; such bonuses are not based on the actual production of oil and gas. Rather, they are the cash consideration paid by the lessee for the execution of the lease, and generally, as here, are calculated on a per acre basis. H. Williams & C. Meyers, *Oil and Gas Terms*, 50 (4th ed. 1976). See also J.A. 6, 8. The bonus is payable without regard to production. See *Shamrock Oil & Gas Corp.* v. *Commissioner*, 35 T.C. 979, 1057 (1961). See also Fambrough, *Taxation of Oil and Gas Payments Received Independent of Production*, 31 Oil & Gas Tax Q. 873, 874-875

(1983). Because lease bonuses are not paid and received "with respect to" the actual production of oil or gas, they are not subject to the percentage depletion allowance. See *Glass* v. *Commissioner, supra*, 76 T.C. at 955.[6]

Taxpayers' reliance (Engle Br. 9-10; Farmar Br. 25) on the court of appeals' statement in *Engle* (82-599 Pet. App. 11a) that if only one barrel of oil is produced, a taxpayer could claim percentage depletion on the full amount of any advance payments, is misplaced. As we indicated in our opening brief (at 23-24), under our theory if one barrel were produced during the taxable year, taxpayers would be entitled to percentage depletion with respect to that one barrel. Contrary to the Farmars' claim (Br. 25), this interpretation does not represent a shift in our position. The proposed Treasury Regulations, published in 1977, specifically deny percentage depletion to advance payments not based on the actual production of oil and gas. Proposed Treasury Regulations on Income Tax, Section 1.613A-7(f), 42 Fed. Reg. 24287 (1977). The proposed regulations also indicate that, in years where both production and income coincide, percentage depletion is allowable only with respect to the receipt of the income based on the actual production of oil and gas. See Proposed Treasury Regulations on Income Tax, Section 1.613A-3(a)(4), Ex. 4, 42 Fed. Reg. 24281 (1977).[7] The Farmars were allowed to deduct

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[6]Some commentators who disagree with our position that advance royalties are no longer subject to percentage depletion agree that lease bonuses are not entitled to percentage depletion because they are not based at all on the actual production of oil and gas. See Note, *Availability of the Percentage Depletion Deduction for Oil Lease Payments*, 36 Tax Law. 817 (1983); Orbach, Dickens & Fields, *A Percentage Depletion Allowance Alternative to* Engle *and* Glass, 31 Oil & Gas Tax Q. 255 (1982).

[7]The Engles contend (Br. 16-17) that we may not apply proposed regulations that were published two years after the taxable year in issue to their case. The argument ignores Section 7805 of the Code, which

percentage depletion with respect to the royalties they received based on the actual production of oil and gas (82-599 Pet. App. 59a n.2).[8] A percentage depletion deduction was disallowed, however, with respect to the lease bonuses because the bonuses were not based on production. See Proposed Treasury Regulations on Income Tax, Section 1.613A-3(a)(4), Ex. 5, 42 Fed. Reg. 24281 (1977). This has consistently been the government's position in this case, and no "shift" in position has occurred.

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gives the Secretary of the Treasury the authority to prescribe all "needful rules and regulations" for the enforcement of the laws (Section 7805(a)) and includes the authority to determine whether to apply a regulation retroactively (Section 7805(b)). Indeed, unless specifically indicated, all rules and regulations will apply retroactively. *Wendland* v. *Commissioner*, 79 T.C. 355, 381 (1982); H.R. Rep. No. 704, 73d Cong., 2d Sess. (1934), *reprinted in* 1939-1 Cum. Bull. (Pt. 2) 554, 583.

In these cases, it is the statute that compels the result that percentage depletion may be allowed only with respect to the actual production of oil and gas. The proposed regulations merely implement the statutory mandate. Accordingly, it was entirely appropriate to rely upon them in the instant cases. See *Manhattan General Equipment Co.* v. *Commissioner*, 297 U.S. 129, 135 (1936); *Dixon* v. *United States*, 381 U.S. 68, 74-75 (1965).

[8]The Farmars attempt (Br. 14-16 & n.19) through a hypothetical to minimize the complexity injected into the tax calculations when the depletion allowance is severed from production during the taxable year. Taxpayers' hypothetical, however, gives rise to precisely the opposite inference; it makes clear that the problems, which were manageably complicated prior to 1975, have become "insurmountable" in light of the production requirements and limitations imposed under the various subsections of Section 613A. See 82-599 Pet. App. 40a (Goffe, J., concurring). Accordingly, the Commissioner's interpretation is not only supported by the language, structure and purpose of the statute, it is also simpler to administer.

For the foregoing reasons, and the reasons stated in our opening brief, it is respectfully submitted that the judgment of the court of appeals in *Engle* (No. 82-599) should be reversed and the judgment of the Court of Claims in *Farmar* (No. 82-774) should be affirmed.

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